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Wholesale distributor of newspapers and magazines; Case studies in auditing procedure no. 09

American Institute of Accountants. Committee on Auditing Procedure

NUMBER 9

CASE STUDIES

IN

AUDITING PROCEDURE

A WHOLESALE DISTRIBUTOR OF NEWSPAPERS AND MAGAZINES

This is the ninth of a series of case studies sponsored by the Committee on Auditing Procedure of the American Institute of Accountants to illustrate actual application of auditing procedures.

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Case Studies

IN

AUDITING PROCEDURE

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A WHOLESALE DISTRIBUTOR OF NEWSPAPERS AND MAGAZINES

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FOREWORD

THE short-form accountant's report or certificate recommended by the committee on auditing procedure of the American Institute of Accountants in 1948, and now in general use, summarizes the accountant's representations as to the scope of the examination in these two significant statements:

(1) "Our examination was made in accordance with generally accepted auditing standards," and (2) the examination, "accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

Auditing Standards

During recent years the committee has given a great deal of consideration to the development of a more explicit statement of the meaning of generally accepted auditing standards. In 1947, it issued a special report, *Tentative Statement of Auditing Standards,* in which it presented the results of its deliberations. The substance of generally accepted standards, as set forth in that report and as adopted by the membership of the American Institute of Accountants in September, 1948, may be summarized as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

Auditing Procedures

A consideration of the foregoing summary of standards will indicate that auditing procedures are the means by which the independent auditor attains or complies with the generally accepted auditing standards applicable to field work. Auditing procedures are so numerous and should be varied so greatly to meet particular circumstances that it is not possible to make an enumeration of procedures which would be applicable generally, or even widely. It is natural that this is the case because if the examination of accounts and financial statements could be reduced to a stereotyped check list of instructions, there would be no need for a public accounting profession. Experienced professional judgment determines the scope and nature of audit procedures to be followed in each individual engagement.

It is the view of the committee on auditing procedure that the most satisfactory method of presenting auditing procedures is through case studies illustrating the auditing procedures adopted and applied in actual examinations. Accordingly, an invitation has been extended to a number of practicing accountants requesting each to submit a comprehensive description of audit work performed on a complete engagement. The following excerpt from a memorandum submitted for the guidance of those preparing case study manuscripts indicates the general nature of the studies:

"The principal objective of the committee, in publishing the series of case studies, is to illustrate typical procedures by which the independent public accountant complies with generally accepted auditing standards in specific situations. Because of the great variety of situations found in performing audit work for different organizations, the public accountant must select and apply those procedures which he feels are necessary and most appropriate in the circumstances. The exercise of sound judgment in the light of the facts of the particular case is of paramount importance in meeting the profession's standards. For that reason, it is believed that case studies, giving rather complete information as to the auditing procedures employed and indicating the considerations involved in selecting and applying those procedures, will do much not only to assure the continuance of high standards within the profession but also to assist those preparing to enter it.

"The pattern that has been established for the case studies is to cover an entire examination selected by the author from a case within his own practice. Using such a case as a basis, the author has prepared a complete audit program to describe fully the work which actually took place. In this connection, it is important that actual procedures should be described even though the author may feel upon reconsideration and with the benefit of hindsight that certain modifications of the program might preferably have been made. The principal purpose of the case study material is to illustrate current practices and not to set forth perfect or ideal models which might be misleading and perhaps even dangerous to hold out as representative of current practice."

The accompanying case study describes the auditing procedures which were actually followed by a practitioner in a particular instance. The procedures used may be applicable only due to particular circumstances surrounding the examination; furthermore, alternative procedures might conceivably have been used to accomplish the general audit objectives. This case study has not been reviewed by the various members of the committee and is not intended as a representation of the views of the committee on auditing procedure.

The committee hopes that the case study material will serve a useful purpose not only within the profession, but also in the various colleges and universities throughout the country which offer advanced instruction in accounting and auditing subjects.

Committee on Auditing Procedure

June, 1951

NO. 9: A WHOLESALE DISTRIBUTOR OF NEWSPAPERS and MAGAZINES

DESCRIPTION OF BUSINESS

Publishers of newspapers and magazines have various methods of getting their publications into the hands of the reader. One of the methods used is distribution through independent wholesale distributors. The wholesale distributor provides delivery and promotion service to retailers in his own city, and also operates truck routes to service suburban areas. Certain customers outside the city are serviced by the wholesaler, either by express shipments from the wholesaler, or by shipments from the publishers direct to the wholesaler's accounts. These shipments are made on the basis of dealer allotments supplied by the wholesaler, who adjusts orders, handles returns, and collects the accounts.

In over 1,250 cities in the United States and Canada, corporations have been organized, and sole proprietorships and partnerships have been established, to carry on the business of independent distributors of the many newspapers and magazines published on the North American continent and elsewhere throughout the world. The majority of the corporate entities are private corporations, and shares are usually held by not more than six individuals.

The primary function of the wholesaler is to secure and maintain proper dealer outlets for the publications he represents. The distribution of newspapers, magazines, and books involves a highly technical and well-organized operation, with management experienced in all phases of the business. In some cases, the owner, partners or stockholders of the corporations are actively engaged in the management; but in many instances, in more extensive operations, the principals have delegated management responsibilities to capable men or women who have grown up with the business.

In many cases, the premises used in the operation of the business are rented, but many distributors have erected their own warehouse and office plants designed to fit the special requirements of the business in respect of receiving, warehousing, shipping, garage, and truck repair, and ample offices required to carry out the necessary accounting and statistical work.

Delivery, sales, returns, and accounting systems must be modern, and mechanical equipment is used as much as possible.

Wholesalers often operate as follows:

1. Newspapers and magazines are received from publishers daily, weekly, monthly, quarterly and annually. These shipments by the publishers are scheduled so that the publications will be placed on sale on regular "release" dates. Shipping costs to the wholesaler are always absorbed by the publisher.

2. These periodicals are ordinarily purchased on a fully returnable basis and are distributed and billed to retail dealers on the same basis. The main reason for this consignment basis is that the publisher wishes the advertiser to pay for advertising on the basis of copies actually sold to readers. In some cases, periodicals returnable to publishers by the wholesaler are limited to a certain percentage of the original amount shipped, and the wholesaler enforces the same conditions on the retail customers.

3. Collections of city retail accounts are made by presentation of weekly statements by drivers of company trucks who also act as collectors. The weekly statement is a complete summary of charges for newspapers and magazines delivered during the week, returned during the week to the wholesaler, balance owing at the beginning of the week (after deducting cash paid), and balance at the end of the week. Bills usually cover the period from Sunday to Saturday, inclusive. Certain charge accounts pay monthly by check even though weekly bills are presented. Country accounts receive monthly statements and must settle their accounts promptly. Customers in the country are billed for express charges on shipments they receive.

4. The returns department handles unsold copies returned by dealers and controls and checks the amount of credit allowed to the dealer. Covers or heads of newspapers and magazines are returned to publishers for credit. To guide the dealer in making returns each week, a printed form showing publications to be returned that week is mimeographed by the wholesaler and sent to dealers in advance. The dealer retains a copy which he uses to check the weekly statement he subsequently receives from the wholesaler. Stripped newspapers and magazines, some of which are

mutilated to prevent resale, are sold weekly to wastepaper dealers.

5. Wholesalers require a competent staff to promote and supervise dealers' merchandising and display to effect largest possible net sales, and the wholesaler must coöperate with the publishers in all advertising and sales promotion operations. Wholesalers maintain elaborate records to show the quantity of each issue (newspaper and magazine) drawn and returned by each retailer. These records are checked by the publisher's field representatives and are the basis for continued good relations between wholesaler and publisher.

6. Wholesalers usually operate their own fleet of trucks for delivery, collection and promotion work. Drivers are, as a rule, accompanied by one assistant, called a "jumper."

7. The wholesaler with adequate warehouse facilities usually prepares separate bundles covering each dealer's magazine, book, and weekly newspaper order, instead of delivering loose copies. The invoice is fastened under the wire used to secure the parcel. Obviously, this speeds up delivery. For daily newspaper deliveries, loose copies are loaded into the truck. The delivery slip for each customer shows the quantity to be delivered.

8. Office staff payrolls, because of the large volume of billing, accounting and statistical work, involve expenditure which is in excess of the amount expended in other wholesale businesses.

9. A competent assistant manager is required to take over full responsibilities in the event of absence of the manager.

10. A formal contract often establishes and outlines the nature of the agency relationship between the publisher and the wholesaler, and some publishers require cash deposits to secure payment of account. Many relationships are maintained by verbal understanding because of greater flexibility.

11. It is important that the system be so designed as to insure that all magazines and newspapers delivered to dealers are billed to the dealers at the proper price, on the proper day. The shipping department prepares the parcels of magazines and books by reference to magazine invoices. Also, dealers must be credited properly for returns, which have been received in good order, fit for return to the publisher. The receiving and purchase system in force should also insure that payments are made only for goods received, at the proper price, that all returns are properly charged back to publishers, and that returns are credited promptly by the publisher.

Magazine and newspaper billings to the retailer are posted from a blotter to weekly statements. To insure that extensions and footings of daily bills to retailers are correct, the total distribution of each publication for that day is multiplied by the respective selling prices and this figure must be in agreement with total billings, as shown by individual invoices. Usually each route is balanced separately. The wholesaler under review has twelve routes.

After the delivery to dealers is made from the total order received from the publisher, very few copies are left over. These are placed in the custody of the assistant manager and are sold only to dealers who require a few extra copies and who come to the office for these copies. Bills are issued for this purpose as no cash sales are permitted.

The manager receives a report of each distribution, showing the disposition of the complete order received from the publisher. This report indicates copies delivered to each route and leftover copies. He makes a count of leftover copies.

As it is difficult to reconcile the quantity of returned publications from dealers with returns to publishers, the office staff is instructed to examine carefully the large return slips. Since these are posted to statistical records, any abnormal items come to the attention of the person who regulates orders. An abnormal return might indicate collusion between a customer and a return clerk.

Detection of Fraud

Gross profit tests disclose any apparent shortages. When these occur, the manager reviews the operations to determine possible methods which may have been employed. Often there may be collusion between a dealer who falsifies return slips, and the clerk in the return department. As it is rather difficult for a driver to dispose of surplus copies in the warehouse, where they are kept under lock and key, and since perpetual book inventories are maintained and controlled by physical inventories, there should be no stock shortages.

If stock is stolen before a delivery is made to dealers, it would show up in a shortage of bundles, because if the original shipment from a publisher amounts to 5,000 copies and 4,972 copies are required to make deliveries to various routes, a loss of three or four bundles, of 50 magazines each will become apparent.

Vigilant management is required to make daily tests of the various operations, as the system must be so arranged as to prevent temptation on the part of any staff member.

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The client corporation under review in this case study, operates a business with sales of approximately $1,000,000 and carries on its business in a city with a population of a million. However, there are other independent wholesaler distributors located in the same city. This client uses leased premises.

They have 1,000 customers located in the city and suburbs, classified as follows:

Type	*No.*	*Accounts Payable*
Cigar & Stationery Stores	800	weekly
Newsstands	138	"
Drug Stores	50	"
Department Stores	5	monthly
Chain Cigar Stores	2	"
Hotels	5	"
	1000	

There are also 150 customers located outside the city and suburbs who are billed for the four or five week periods, and who pay bills once a month, although the shipments to these accounts are made weekly by express. In addition, accounts are maintained with about 50 wholesalers to whom our client distributes publications handled on a national basis.

Magazines, newspapers and books are purchased from 40 publishers and 500 different items are handled. Magazines and books are delivered three times a week; newspapers are delivered daily, including Sundays.

For practical reasons, the fiscal year consists of 52 or 53 weeks ending on the closest Saturday night falling at the year-end. Books are closed periodically during the year on a four or five week basis. This closing method is logical because bills to customers end on Saturday, newspaper publishers and certain magazine publishers charge on that basis, and inventories can easily be taken because most returns to publishers are made Saturday morning. Inventories are, therefore, at their lowest.

The audit engagement is recurring; annual audits have been made in prior years. We make a complete survey of the company's accounting system and of its system of internal control prior to the auditing date. Suggestions for improving the systems are submitted in a separate letter to the management of the company.

To illustrate the accounts involved in a typical wholesale distributor's operation, there follow the balance-sheet and profit and loss statement, condensed and suitably disguised.

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ASSETS

CURRENT ASSETS:

Cash in bank and on hand		$50,000	
Marketable securities—at cost (market value $5,100)		5,000	
Customers receivables	$45,000		
Less allowance for bad debts and unearned gross profit	2,000	43,000	
Miscellaneous receivables—loans, etc.		400	
Inventories of saleable magazines, books and newspapers on hand and in transit and merchandise returnable to publishers as determined and certified by the management and valued at cost, which was the same as market value		25,000	$123,400

OTHER ASSETS:

Deposits with publishers	$9,000	
Other deposits—public utilities, post office, & customs	1,000	10,000

FIXED ASSETS AND DELIVERY EQUIPMENT:

	Cost	Accumulated Depreciation	
Furniture, fixtures, warehouse, and office equipment	$ 9,000	$ 4,000	
Automobiles and trucks	19,000	8,000	
	$28,000	$12,000	16,000

DEFERRED CHARGES:

Unexpired insurance	$ 1,200	
Prepaid shipping expenses and stationery supplies	700	1,900
		$151,300

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30, 1950

LIABILITIES AND CAPITAL

CURRENT LIABILITIES:

Trade accounts payable—publishers		$ 45,000
Other current liabilities		
Sundry creditors	$ 2,000	
Withholding taxes, etc.	1,000	3,000
Accrued liability for merchandise received not billed by publishers		5,000
Provision for federal taxes on income		10,000
		$ 63,000

OTHER LIABILITIES:

Customers deposits		5,000

CAPITAL STOCK:

Authorized—500 common shares of the par value of $100 each	$50,000	
Issued and outstanding—200 common shares of par value of $100 each		20,000

RETAINED INCOME:

Balance—December 31, 1949	$43,300	
Net profit for the 52 weeks ended December 30, 1950	30,000	
	$73,300	
Dividend on common shares	10,000	63,300
		$151,300

CONDENSED STATEMENT OF PROFIT AND LOSS

52 weeks ending December 30, 1950

	News-paper	Magazines & Books	Total
Net Sales.	$250,000	750,000	1,000,000
Cost of Sales	212,500	637,500	850,000
Gross Profit	37,500	112,500	150,000
Ratio of Gross Profit to Sales.			15%
Deduct—Loss on unsold copies of newspapers, not returnable to publishers .	5,000		5,000
	$ 32,500	112,500	145,000
Selling Expense and Delivery Costs		55,000	
Administrative and General Expenses		55,000	110,000
Net Profit from Operations.			35,000
Other Income:			
Delivery charges to customers, waste paper salvage, income from publishers for handling services, bond interest, interest on publishers' deposits			15,000
			50,000
Provision for Federal Taxes on Income.			20,000
Net Income to Retained Income			$ 30,000

ACCOUNTING RECORDS

The principal accounting records and their content are as follows. Their use is fully described in various sections of the case study.

Record	*Content*
General Ledger	Asset, liability, allowances for bad debts and depreciation, capital, retained income, and all income and expense accounts. Contains various controlling accounts for receivables, payables, customers' deposits, automobile and trucks, warehouse and office equipment.
Accounts Receivable Ledger (city dealers)	"Boston," horizontal type used by public utilities. Records gross sales, returns and cash paid by customers. Periodic refunds and bad debt write offs are entered when necessary.
Accounts Receivable Ledger (country accounts)	This is similar to the above ledger, except that entries are made on a monthly basis instead of weekly.
Accounts Receivable Ledger (wholesale accounts)	Contains accounts with other wholesalers who receive shipments from client who may often handle national distribution of certain periodicals. This is the usual type of debit, credit, loose-leaf ledger. Sales and returns are posted from a sales journal maintained specifically for this ledger.
Cash Receipts Books (a) Subsidiary (b) Condensed Summary	This records individual checks received from customers, publishers, etc., as well as total cash received from each driver. This book is balanced daily and reconciled with the bank deposit. Totals of each column reflecting various controlling accounts are then transferred to condensed cash receipts book.
Collection Sheets	No names are recorded but code numbers are used for every dealer showing route number and account number. For example, Driver A on Route 1 will have a sheet as follows:

Customer	Amount Paid	Amount Refunded
1–1	$10	
1–2	5	
1–3	15	
1–4		$12
Totals		

	(NOTE: This code system is also used in accounts receivable (city ledger) weekly statements, returns slips (and parcels containing returns from customers), reorder and pick-up slips. The use of code system facilitates posting work.)
Accounts Receivable (recapitulation book)	This book is a summary of all totals in the accounts receivable ledgers and is the basis for a journal entry charging accounts receivable and crediting sales. It also reflects total cash credited to customers, which agrees with cash book totals at the end of each four or five week period. The balances at the end of each period, in total, are also in agreement with the control account balance in general ledger. A separate recapitulation is made for country accounts.
Property Ledgers (a) Automobiles and Trucks	Asset account and allowance for depreciation for each automobile and truck with full details.
(b) Warehouse and office equipment	Asset account and allowance for depreciation for each item purchased at cost of $200 or over. Grouped account for miscellaneous items.
Customers Deposits Subsidiary Ledger	Reflects deposits received from customers and records refunds at various times. Visible index type of ledger is used, containing small ledger sheets. Three binders are necessary, each containing about 250 accounts.
Drivers "Over and Shorts" Subsidiary Ledger	This records amounts due to or by drivers and is posted daily from subsidiary cash receipts book and petty cash envelope.
General Journal	Original book of entry for miscellaneous entries, sales totals, monthly accruals, and provision for monthly pro rata expense and depreciation charges.
Purchase Journal (newspapers and magazines)	Recording and distribution of all weekly and monthly purchase invoices (plus or minus adjustment of returns).
Purchase Journal (miscellaneous)	Distribution and recording of purchases of supplies and services.
Return Journal (newspapers and magazines)	Records weekly returns to publishers and miscellaneous charges for interest, sundry allowances, and interest on deposits.

Main Blotter (city)	This is one of the important factors in the operation of the sales system. The blotter totals, in dollars, for each route, each week, must agree with total charges shown in the accounts receivable ledger for the same route. Weekly statements to dealers, which show value of publications delivered, are posted from the main blotter, which records quantity and value of each daily newspaper and value of magazine charges on each delivery date. The blotter also records delivery charges for the week. It should be noted that delivery slips for daily newspapers are not prepared in duplicate and show quantities only. Magazine bills as well are not prepared in duplicate, but are posted singly from distribution records, using a pegboard system. One clerk calls figures to another who posts to the invoice. However, magazine bills are extended and totalled. The magazine bills therefore must be posted to the main blotter before release to drivers. Sunday (weekly) newspapers are classified as magazines. The delivery slips for daily newspapers are summarized on a subsidiary blotter and weekly totals are posted to main blotter. A separate blotter is maintained for country accounts which receive sundry newspapers and magazines.
Distribution Records (magazines, books and weekly newspapers)	Postings are made to invoices from these records, which are adjusted or repeated for each weekly or monthly distribution. Entries in distribution sheets appear in pencil figures. A separate sheet is used for every publication. Returns from customers, in quantities, are posted from return slips to this record to give a complete story of the "draw" and "return," although the latter is purely statistical. This furnishes "net sale." Each line lists a dealer's name or code number. Each issue of a publication is recorded, and thus the progress of circulation permits adjustment of new orders for subsequent issue.

Perpetual Inventory Record (books only)	A separate section is maintained for each publisher to show the quantity of books received and the date received. Titles are not segregated separately. When shipments are made weekly to dealers, appropriate entries are made from distribution records. In the same manner, returns to publishers are posted from publishers' return slips and returns from customers are posted from customers' return slips, in one total for the week.
Publishers Record of Draw and Returns	This shows for every issue of weekly newspaper, magazine and book, the number of copies received and the number of copies returned to the publisher. This gives the net sale of each issue.
Price Book	An alphabetical list of the publications handled. It furnishes cost and selling price to the dealer. It is very useful in checking publishers' bills, completing return slips to publishers, and computing inventories at cost.
Cash Disbursements Book	A columnar book, suitably analysed to record all checks issued. It is the only record required to list disbursements because petty cash disbursements are listed on envelopes weekly.
Accounts Payable—Publishers (subsidiary ledger)	Records credits as follows: Purchases, refunds, interest on deposits. Records debits as follows: Returns, disbursements for publishers' account, interest charged, shipments to other wholesalers, payments by check.
Accounts Payable—Miscellaneous (subsidiary ledger)	Accounts with miscellaneous suppliers and service organizations.
Receiving Book	This book is indexed, a separate section being maintained for each publisher. Entries are made daily to show date of receipt, name of publication, quantity, date of distribution, and quantity distributed. Shipments to the wholesaler for subsequent delivery to customers outside the city are recorded in separate columns because distribution dates may not coincide with city distribution

dates of similar publications. Entries covering receipts are made by receiving clerks who note shortages, if any. Distribution dates are entered by assistant manager.

Inventory Book — This is a loose-leaf record containing monthly inventories taken and computed as explained in this study.

MAJOR ACCOUNTING POLICIES

The company's chief accountant prepares periodic balance-sheets and profit and loss statements, copies of which are forwarded to us during the year and reviewed for unusual items or problems which require discussion during the year. Profit and loss statements are prepared in detailed form showing cumulative and periodic figures for the year under review.

Customer's bills must be paid on due date. If not, further shipments are stopped. The reason for this is obvious. Wholesalers must remit to publishers promptly and accounts cannot be carried, as here is a danger of complete loss in the event of bankruptcy. Cash sales are not permitted to dealers. All shipments are billed and charged to accounts receivable, including all reorders required by customers.

An allowance for bad debts is carried, but losses have been insignificant. It is necessary to set up an allowance for unearned gross profit on amounts included in receivables covering possible returns of consignment merchandise fully returnable.

Perpetual inventory records are maintained to control the sale of books. They are reconciled quarterly with physical inventories. To expedite preparation of inventory sheets, the forms used by the stockkeepers are prepared in advance to show names of publications. After quantities are filled in, these inventory sheets are placed in a loose-leaf binder and extended and totalled by the office staff. Merchandise in transit, covering publications billed by publishers and received subsequent to closing date, are also included in the inventory. Inventories are always carried at cost.

Receiving records are written up daily and each publisher's shipments are recorded in a separate section to facilitate checking with publisher's invoices and statements. The receiving records provide for insertion of the distribution dates of publications.

The general ledger is classified in balance-sheet and profit and loss form as statements are taken off by the chief accountant directly from the general ledger.

Accounts receivable control accounts are balanced and reconciled weekly to eliminate errors being carried forward. Separate controlling accounts are maintained for city dealers, country dealers, and wholesale accounts. Detailed lists of outstanding accounts receivable, appropriately aged, are prepared quarterly, and delinquent balances at end of each week are scrutinized carefully.

The assets recorded in the fixed assets and delivery equipment accounts are carried at actual cost. Detailed ledger accounts are maintained for each truck or automobile to show cost, and the status of the allowance for depreciation. Depreciation is provided on trucks at maximum rates permitted by taxation authorities. The trucks and automobiles are compared annually with these records to verify their physical existence. Records are maintained for each car to record mileage, maintenance expenses, including depreciation, and operating cost per mile. Fleet auto insurance is reviewed several times a year to see that all trucks are adequately insured and that adjustments are made for trade-ins and new acquisitions.

Details of office and warehouse equipment, furniture and fixtures are maintained in a subsidiary ledger showing cost and allowance for depreciation, and are checked annually with a physical inventory.

Prepaid expenses are recorded at cost and are amortized on a periodic basis.

All disbursements, except minor disbursements, from petty cash, are made by check.

The imprest petty cash system is used, reimbursed weekly. The chief accountant counts cash on hand and balances the total fund weekly. Salaries and wages are paid by check only. Cash is reconciled and deposited daily.

Accounts receivable ledger postings are made every morning direct from drivers' collection reports which are kept in the clients' regular safe overnight until postings are made next day. Before being posted to the ledger the additions are again checked to prevent insertion of sums by unauthorized persons. Two safes are used—one for books and records, the other for cash funds.

It is not the company's policy to invest its surplus funds in marketable securities to any great extent. Temporary investments are made in government securities but are sold when cash is required. All bond transactions are handled by the company's regular bankers, who furnish purchase and sale memoranda.

For convenience, investment income and interest on deposits are recorded on a cash basis, but all other transactions are recorded on an accrual basis of accounting.

A voucher system is not required in this business, but two separate control accounts are maintained, for publishers and other trade liabilities. Because of the receipt of publications prior to each balance-sheet date, which are not billed by the publisher until the following period, the careful computation of accrued liabilities is of special significance.

Capital stock is carried at par value and previous examinations have revealed that cash had been paid into the corporation for the entire value of the stock outstanding.

Retained income represents the accumulation of net profits, less dividends paid, since commencement of business. An annual dividend policy is in force to avoid taxation of retained income accumulated beyond the needs of the business.

The major accounting policies are outlined in our working papers so that we can determine whether they are being followed consistently, and that they are in accordance with accepted accounting principles.

The work incidental to the annual audit under discussion was spread over the fiscal year as follows:

1. Review of system of internal control—senior and one assistant for one week in October.
2. Confirmation of accounts receivable—one senior and two assistants for one week; namely, first week in December.
3. Observation of physical inventories—one senior on last day of fiscal year.
4. Cash count—one senior the last day of fiscal year.
5. Final work—one senior and two assistants for one week after close of fiscal year, starting January 22.
6. Review of periodic balance-sheets and profit and loss statements—$^1/_2$ day each month—senior and partner.
7. Review of copies of all corporation tax returns prepared by chief accountant (as received from client).

The client's staff prepares all working paper schedules required by us on our forms, headed up appropriately by us. The audit is therefore expedited to a considerable extent and we are free to devote all energy and thought to auditing procedures and preparation of our audit reports, instead of routine mechanical work on schedules which can easily be drawn up by the client's staff.

REVIEW OF INTERNAL CONTROL

We review the permanent file of working papers in connection with the system, and discuss with the chief accountant changes in system during the year under review and reasons for changes. It is necessary to observe each operation in effect by following through a transaction and procedure from beginning to end and discussing it with the client's staff responsible for the work.

Cash Receipts

System

Cash receipts are classified as follows:

1. Received by cashier:
   a. Collections made by company drivers.
   b. Payments of accounts by customers who visit the office.
   c. Payments of collection shortages by company drivers.
   d. Payments by employees on account of loans.
2. Received by mail:
   a. Payments of accounts by customers who pay by check or money order.
   b. Refunds from publishers and receipts for sale of waste paper, bond interest, etc.

Collections made by company drivers are supported by detailed collection sheets. The drivers make entries on these sheets as they make the rounds of dealers who pay by cash or check. Credit balances due customers are refunded by the drivers. No returns of publications are deductible, even though they are picked up on collection days. The weekly statement presented to dealers is payable in full, although partial payment is accepted in special circumstances. During the course of the day, drivers purchase post office or bank money orders payable to the company to reduce hold-up risk. This also saves the time of the cashier who checks the collection. The weekly statement is receipted by the driver and turned over to the customer. When, on certain days, a check-up of dealers' unsold copies of publications is made, the collection sheets, with names of dealers in route order, are used. This saves the drivers' time and also serves its purpose as promotion material.

If the amount turned in is in excess of the total shown on the collection sheet, the difference is credited to the driver because this may represent an item collected from a customer but not listed. Later in the week when an attempt is made to collect an amount apparently outstanding and on presentation of a receipted statement by the customer, a journal entry is made charging the driver and crediting the customer. After all adjustments, a credit still appearing is refunded to the driver as it represents his own funds. A shortage, which exists because cash is less than the amount shown on the drivers' reports, is charged to the driver and must be paid by him. The above differences, though insignificant in amount, must be handled systematically.

The total collection turned in by the driver is listed in a subsidiary cash receipts book, split up as follows if cash is over

Cr.	Accounts Receivable	$1,000		
Cr.	Collector	5	$1,005	Total

If cash is short, the entry is—

Cr.	Accounts Receivable	$1,000		
Dr.	Collector	5	$995	Total

Payments received from customers who come to the office are not frequent, but if this occurs, the bill is receipted and the item is immediately entered in the subsidiary cash receipts book. The same procedure is applicable to payments of shortages by drivers. A special form of receipt is issued from a prenumbered duplicate receipt book.

The mail is opened only by the manager who places an endorsement stamp on each check or money order and keeps them in a special Brinks safe until deposited.

A bank deposit slip is made up first thing every morning and covers all receipts of the previous day. After the deposit slip is reconciled with total cash, it is replaced in the safe until called for by a Brinks express representative, who takes the funds to the bank and returns the receipted deposit slip to the client the next day.

Audit of System

1. Determine that receipts are deposited daily.
2. Inquire whether drivers' reports are placed in the regular safe overnight after the adding machine tape of detailed items is attached and cash has been checked. This prevents unauthorized persons from inserting sums which may have been pocketed. Ascertain that the ledgerkeeper checks the adding machine tape before posting to the accounts receivable ledger the following day.
3. Ascertain whether the drivers' over and shorts subsidiary ledger

is in agreement with the controlling account and that payments to drivers or receipts for shortages are cleared weekly.

4. Ascertain whether the manager compares the daily deposit slip with the cash-book entries.
5. Compare daily receipts from charge accounts for one week with a summary prepared by us for this purpose from entries in the cash columns of the accounts receivable ledger.
6. Foot and cross check the cash receipts book for one month.
7. Reconcile total deposits shown by the bank statement with receipts shown by the cash receipts book for one month.
8. Trace deposits of receipts from the cash receipts book to the bank statement for one month.
9. Check the postings of all totals in the cash receipts book to the general ledger for one month.
10. Check the postings from the collection reports and the cash receipts book for one week to the accounts receivable ledger.

Cash Disbursements

System

Cash disbursements are classified as follows:

1. By check
2. By currency from the petty cash fund

Disbursements by check consist of the following:

a. Payment of publishers' weekly or monthly statements and liabilities incurred for miscellaneous expenses.
b. Special items, refunds to customers
c. Payments to customs brokers for clearing foreign shipments which are immediately charged back to publishers through the cash disbursements book.
d. Reimbursement of petty cash fund.
e. Reimbursement of payroll bank account.

Payments to publishers who submit weekly statements of account are ordinarily paid in full; i.e., a check is issued for publications charged for one week. No deduction is made for returns in transit. This follows the same pattern expected of the client in collecting his bill from the dealer. The quantity shown on the statement is, of course, checked to receiving records, and extensions and calculations are verified. Payment of the items is then entered in the purchase journal.

Publishers who submit monthly statements are also paid in full. Here again no deduction is made for returns in transit, except in the cases of publishers who are handling special items or whose credit standing is not well known.

Miscellaneous expense bills and brokers' statements are paid weekly. Voucher checks in duplicate are prepared after the invoice is signed by the chief accountant. The duplicate check is stapled to the invoice or statement. All receiving slips, properly executed, covering the purchase of miscellaneous supplies are attached to the expense invoices. Checks for reimbursement of the petty cash fund are made payable to the cashier and are supported by a petty cash envelope ruled on its face to reflect the proper analysis of the expenditures for distribution in the cash disbursements book. Petty cash vouchers are stapled and placed inside the envelope. Cancelled checks and bank statements are received directly from the bank by the chief accountant, and the bank accounts are reconciled by him. Reimbursement of the payroll bank account is explained later.

Audit of System

1. Determine that vouchers are approved for payment only if supported by proper documents (expense bills and payments to customs brokers) and that publishers' invoices or statements are paid only after comparison with receiving records and "price book" of publications. Also determine that extensions and footings are properly checked by the client's personnel. Because of frequent price changes it is necessary to maintain an alphabetical list of publications received from each publisher which reflects cost and selling price of each item handled.
2. Determine that invoices are properly cancelled when approved for payment so as to prevent re-use.
3. Determine that bank accounts are reconciled periodically by the chief accountant.
4. Foot and cross-foot the cash disbursements book for one month.
5. Check the posting of all totals with the general ledger for one month.
6. Trace transfers from the general account to the payroll account.
7. Compare checks issued for one month with the cash disbursements book. Examine names of payees, amounts, and endorsements. Determine that checks are not made out to "cash." Then compare duplicate checks with supporting vouchers attached, with cash disbursements book entries for one month; and see that all supporting documents are attached and that each

invoice or statement is properly verified as to receipt of goods or services, prices, extensions, etc.

All payments, with the exception of petty cash, payroll and refunds to customers, must be processed through the accounts payable ledgers. Refunds must be supported by written requests from the customers. Refunds for one month must be traced to the accounts receivable ledger or the subsidiary customers deposits ledger.

Payroll transfers from the general account to the payroll account must agree with the net payroll shown in the payroll book.

Petty cash checks must be supported by properly prepared voucher envelopes. Inspect disbursements of petty cash for one month and see that vouchers are properly mutilated, that no wages are paid by petty cash and that refunds to drivers are properly handled, as explained in the cash receipts section.

Accounts Receivable and Sales

System

City Accounts

Weekly statements are prepared by billing clerks in duplicate for all city accounts. The dealer has, of course, previously received daily delivery slips for newspapers and a separate bill for each magazine and book delivery. The dealer also has retained a duplicate of his return slip covering returns to the wholesaler.

The weekly statement is merely a copy of the summarized totals in the blotter, and shows the quantity and value of each newspaper delivered during the week and the totals of each magazine delivery. Customers' return slips, after being checked by the receiving department for quantities and by the office for extensions and totals, are posted directly to a columnar loose-leaf accounts receivable ledger. From this ledger, the return is then posted to the statement. The total gross charge is then posted to the ledger. Short margin sheets are used in the ledger to give the desired room for accommodating a specific period of, say, six months. This combined ledger and sales journal is in route order. A separate ledger is used for each route.

The ledger gives the following information:

Name	*Balance*	*Cash*	*Balance*	*Gross Charge* w/e	*Returns* w/e	*Balance*
	July 29	July 31–Aug. 5		Aug. 5	Aug. 5	Aug. 5
Smith	$10	$10		$17	$2	$15

Returned checks and refunds are entered in red ink in the cash column. Bad debts are inserted at end of year only.

The gross charge column per the ledger for each weekly period is cross-checked with the gross charge column in the main blotter.

The use of a return column in the ledger serves as a check on subtractions made in the weekly statement where returns are deducted from gross charge. Although the ledger has a return column, the sales account is credited with "net" sales only.

Duplicate magazine delivery invoices are not ordinarily used but are mimeographed as required for specific deliveries. The July 29th balance paid in full as above, is not carried in a *previous balance* section of the statement, nor is the cash collection shown on the customers statement of August 5th. If a partial payment is made, the previous balance section reflects the balance due at the end of the previous week, less the partial payment.

Cash collected is posted to the ledger directly from the drivers' collection sheets or from the subsidiary cash receipts book. Drivers' collection sheets are added when first brought in and this total must agree with the cash turned in or the differences must be charged or credited to the driver.

Each ledger page is cross-balanced and all pages are summarized for each week, and then for four or five week periods. The summary gives the following information:

Balances—July 29
Add: Net Bills—July 30–Sept. 2
(Dr. Accounts Receivable—City Accounts.
Cr. Sales Account.)
Deduct: Cash (July 30–Sept. 3).
This must agree with cash receipts book.
Balances—Sept. 2

To record daily newspapers billed, a delivery slip showing quantities only is sent to dealers. For each route a preliminary blotter is used showing the name of the dealer and the quantity of each newspaper taken. The total for the week is extended at selling price for each route and cross-balanced. Extensions are proved by adding daily and weekly quantities and multiplying by the selling price. Weekly quantities taken by each dealer and the total charge are then transferred to the main blotter.

The main blotter lists city dealers' names in route order. It records the quantity of each daily newspaper delivered for the whole week and the total value of these papers. Space is provided for insertion of charges for magazine deliveries, reorders and weekly delivery charges. The blotter is cross-balanced at the end of each page. Weekly service charges are totalled for each four or five week period and a journal entry is made debiting the sales account and crediting "Income from Delivery Charges."

Wholesalers Accounts

The wholesaler under discussion handles the complete print for certain magazines in a large territory and, on behalf of a publisher, makes shipments of large quantities to other wholesalers. A special type of invoice (prenumbered) is used in duplicate. The original, with full details, is sent to the customer and the duplicate is filed on a binder. The usual type of sales journal is used for this purpose and returns are confirmed by use of credit notes. These accounts receive monthly statements on regular statement forms suitably ruled.

Country Retail Accounts

There are two methods of billing these accounts.

1. The publisher ships directly to the wholesaler's customer and furnishes details to the wholesaler, who then charges his customer.
2. The wholesaler ships by express from his own premises and forwards an invoice with each shipment. Monthly statements are prepared in duplicate and entries are made in the same manner as explained for city retail accounts, from a separate blotter, except that the ledger is maintained on a monthly basis.

Reorders and Pick-ups

Dealers return magazines and newspapers for credit weekly. However, each week a redistribution of magazines is also made, handled by the driver on his regular collection route. The redistribution involves taking back copies from some dealers and giving other dealers additional copies.

The driver is furnished with charge slips and credit notes in duplicate and returns to the office with these slips, which balance one another. The accounting office then makes the appropriate entries in the blotter. No cash transactions are permitted for redistribution. Redistribution is required by publishers to insure the best possible sale of publications.

In some cases, the number of copies taken from some dealers is in excess of the number of copies given to other dealers and the following situation arises:

Dealer pays collector	$1,000	
Collector takes 100 magazines from dealer		
Issues credit note for		$25

Collector delivers 50 magazines to other dealers
Issues charge slips for. $12.50
Collector checks in as follows
Cash $1,000
Magazines brought in 50
Values $12.50, covered by net credit notes for $12.50

In most cases, however, copies picked up are handed to other dealers so that charge slips brought in equal credit notes issued, and no publications are brought back to the office.

Audit of System

City Accounts

1. Check return slips from dealers for any week in December with entries on duplicate weekly statements. "Pick-up" credits are included in this test.
2. For the same week, summarize in the audit working papers the gross charge column in the blotter for the twelve routes, and compare this total with the gross charge column shown in the accounts receivable recapitulation book.
3. Take off an adding machine tape of reorder slips for the month of December and compare with totals shown in the blotter.
4. Magazine bills are not prepared in duplicate. A customer may lose original bill. Therefore, have the manager illustrate how the wholesaler can advise the customer what publications were delivered on a certain day, by referring to distribution records.
5. Compare preliminary blotters (newspaper delivery) with entries in main blotter for one week in December.
6. Check additions and cross-balance pages for one route in main blotter for last week in December.

Wholesale Accounts

1. Compare duplicate invoices and credit notes for the month of December with entries in the sales journal.
2. Check all postings in the subsidiary ledger for November to the sales journal and cash receipts book.
3. All wholesalers place with the client written orders which specify the number of copies of magazines desired. These letters are used by the shipping department to fill orders and are then filed in date order for each month. Compare these orders with invoices for any month of year.

4. Compare bills from the express company with duplicate invoices for one month. Test check a few large shipments by ascertaining the weight of specific quantities of magazines, and note whether the express bills coincide.
5. Compare wholesalers debit notes sent to the client for returns with credit notes issued by the client for the month of November.

Country Accounts

1. Compare the blotter total showing gross charges with the gross charge column in ledger for one month.
2. Check postings from the cash receipts book to the ledger for month of December.
3. Check return slips from customers with entries in the ledger for month of December.

Trade Creditors

System

Publishers of newspapers, as a rule, send weekly statements to wholesalers. These statements show the quantity and cost of daily and Sunday papers shipped, and the quantity and value of papers returned for credit, as well as checks received from the wholesaler. The beginning and ending balances are, of course, shown.

As explained previously, "headings" of unsold papers are returned weekly by parcel post.

After the "headings" have been sorted and counted, return slips are made up for insertion in the parcel. A separate return book is usually kept for each publisher. This is a bound book with duplicate slips, one of which remains in the book. Only the name of the publication, the issue, and the quantity are shown on the original which is sent out. The duplicate is then extended at cost (by reference to price books) and totalled. An entry is then made in the returns journal to show the date, the name of the publisher and the amount charged to the publisher's account.

The same procedure is, of course, adopted for magazines (covers) returned. The returns journal is also used to record other miscellaneous charges to the publisher based upon the agreement. For example, a wholesaler often clears bulk shipments and arranges rail routing to other cities on behalf of the publisher. Interest on deposits may be credited by the publisher direct to the statement, in which case it is necessary to charge the item through the returns journal, which has a separate column for this purpose.

The gross charge for the weekly "draw" of newspapers is credited to the trade account, through an entry in the purchase journal.

Returns and other debits are recorded through the returns journal. Cash paid is, of course, charged from the cash disbursements book along with payments to customs brokers applicable to the specific publishers account. Some publishers send refund checks covering charges made by the wholesaler for services.

A publisher often does not allow all credits claimed if copies are returned too late. However, if a publisher neglects to credit long outstanding return items, letters must be written ascertaining reason therefor.

If entries are made each week, theoretically the balance shown as owing by the newspaper publisher at the end of each four week period should agree with the accounts payable ledger account. But here is what happens in practice:

1. The amount of returns credited by the publisher may be greater or less than the amount charged in the ledger account. If not in agreement, the reason must be ascertained, and if the publisher's calculation of returns is correct, based upon details supplied by the publisher, an entry covering purchases for the following week is increased or decreased. For example, suppose the wholesaler extended his slip erroneously and charged $10 to the publisher and the correct calculation reads $9. A $1 adjustment is made.

2. Certain returns may have been received by the publisher but not yet credited.

3. Certain returns may be in transit.

4. Checks may be in transit.

As a final proof of the accuracy of the entries, the following reconciliation is attached to final statements for the fourth or fifth week in the period, or to the magazine publishers' monthly statements.

Balance per publisher's statement—December 30, 1950		$1,000
Deduct:		
Dec. 24/50 Checks in transit	$400	
Dec. 24/50 Returns in transit (details)	50	
Dec. 22/50 Miscellaneous—brokerage charge	10	460
Balance per ledger—December 30, 1950		$ 540

Magazine publishers usually submit monthly statements, but the principles explained above apply as well; except that, whereas entries for returns and cash transactions are made weekly, entries for monthly purchases are made only once a month, and the simplest way to adjust "return slip" differences is to note on the copy of the return slip the amount allowed, and on the publisher's statement to indicate by plus or minus notation what will be added to the value of the gross draw. This eliminates numerous journal entries.

Often, the wholesaler reships certain copies to other wholesalers as instructed by the publisher. These must be charged to the publisher in the same manner as returns. In addition to this, subscriptions taken by the wholesaler and billed to a dealer are charged by the publisher and must be added to the month's purchases after the charge by the publisher is cross-checked to the duplicate subscription order book.

The majority of publishers desire that wholesalers pay the monthly or weekly statements rendered in full, making no deduction whatsoever for returns shipped by the wholesaler but not yet credited by the publisher. If, however, a check has been issued by the wholesaler, and is still in transit, a deduction is usually made because of such payment. Most publishers have a notation on their statement to the effect that their bills are payable in full, as per balance shown.

Of course, the wholesaler also deals with some smaller publishers, who it is found by experience are not consistent as regards the accuracy of their statements or the promptness in crediting returns. In cases of this kind, the wholesaler deducts all returns to date of payment.

Audit of System

1. Check the posting to the general ledger control from the purchase journal, the purchase returns journal, and the cash receipts and cash disbursements books for one month.
2. Inquire whether reconciliations are attached to all monthly and weekly statements to show the tie-up between bills and the ledger.
3. Ascertain whether letters are written promptly to publisher when returns, etc., are not credited promptly or when overcharges have been made for publications received, etc., and if the latter, determine whether debit slips are forwarded promptly to the publishers.
4. Determine that trial balances of the accounts payable ledger are prepared each month and agree with the general ledger control.
5. Pick out several of the larger statements for one month and check the following:

   a. Prices to the price book.
   b. Differences between returns charged to the publisher, and the amount credited, ascertain the reasons.
   c. Reconciliations between the statement balance and the ledger balance.
   d. Quantities of publications charged, against receiving records or inventories, at the end of the period.
6. Ascertain that all invoices and statements for December are properly approved, for
   a. Receipts of publications.
   b. Footings and extensions.
   c. Prices.

Gross Profits Test

System

The purchase journal records purchases at cost and selling price for both newspapers and magazines.

The bookkeeper who performs this work must refer to the price book, which shows the cost and sales price, in alphabetical order for each publisher, of every publication distributed. Selling price totals are not posted to the general ledger but are used as memos only for the gross profits test.

The recording of purchases at selling price enables the client to compute the percentage of mark on, and so arrive at the gross profit which should be earned on sales. This is compared with ratios shown on the profit and loss statements.

An alternative method of testing gross profits for smaller agencies is to compile figures for each publication sold, showing the net copies distributed, and to multiply this by the profit earned on each publication.

The number of copies distributed is obtained from the receiving book and returns are computed from return slips sent to publishers for the period under review. When this method is used, profits are usually grouped to show what is earned in handling each publisher's account and this information is very valuable.

Receiving records show the date each publication was received and, on the same line, the date the publication was distributed.

Inventory quantities at the beginning and end of each four or five week period can be ignored as most publications are returned promptly to publishers each Saturday.

Audit of System

Whatever method is in effect, we compare statistical reports with the gross profit shown on the profit and loss statements and make inquiries to ascertain reasons for any differences.

In this case, the first method described is used. We therefore check:

1. The posting of the cost and selling price columns to the original records for one month.
2. The footings of the purchase journal and the calculation of gross profit and compare it with the profit and loss statement for that month.
3. The gross profit ratios for the full year, comparing cumulative figures with monthly averages and ascertaining the causes for variance from the previous year's gross profit.

If a difference of more than one-half of one per cent exists, we discuss with the management the possibility of fraud and, if authorized, make a special investigation of the sales and returns system. Often, errors in the computation of inventories and accruals may distort gross profit figures in the profit and loss statement. Therefore, it is sometimes advisable to await the results of the following month's operations before arriving at the conclusion that fraud exists.

Only one sales account is maintained in the general ledger as a result of postings from the accounts receivable ledger. This of course reflects "Net Sales" and includes delivery charges to customers, which are charged weekly and are totalled in the blotter.

Since the purchase journal and purchase returns journal reflect purchases and returns of magazines as well as newspapers, and inventories can easily be analyzed the same way, there is available a "Cost of Sales" account for each department.

To arrive at "Net Sales" of newspapers, it is necessary to calculate at selling price, the net quantity sales of newspapers by reference to the receiving records and the purchase returns journal. A journal entry is then made as follows:

Sales Control	Dr.	
Newspaper Sales		Cr.
Magazine & Book Sales		Cr.
Delivery Charges to Customers		Cr.

Loss on Unsold Publications Not Returnable to Publishers

Some publishers do not allow full returns but require the wholesaler to give full credit to his dealers. The returns clerk segregates these publications when checking returns from dealers, but instead of shipping them to the publisher, merely lists the quantities on a special form. These are extended at cost price by the office and a journal entry is made charging the amount to the expense account and crediting the purchases account. This item is shown separately on the profit and loss statement so that the wholesaler can see what this cost amounts to and so make representations to the publisher, if necessary, for a special annual allowance.

Miscellaneous Suppliers and Service Organizations

System

All invoices are approved by the individuals receiving the goods or services. Footings and extensions are checked. A separate purchase journal is maintained and a separate accounts payable subsidiary ledger is required. Each month a trial balance of this ledger is prepared and reconciled with the control account. All invoices are paid daily upon receipt, unless weekly or monthly statements are received and terms arranged on that basis. Payments are made promptly so that any purchase discounts can be taken.

Audit of System

1. Determine that a trial balance is taken each month.
2. Note the age of any old items outstanding and secure explanations.
3. Check postings to the general ledger control for one month from the books of original entry.
4. Check one month's entries in the purchase journal to appropriate invoices and see that they are properly approved.

Payroll

System

Employment is effected through the manager or assistant, and rates of pay and subsequent changes are communicated in writing to the payroll clerk. The client normally employs 50 persons.

Employees punch time cards and the payroll clerk prepares weekly payrolls by computing earnings and deductions, and posts in one operation by hand to individual earnings records, payroll sheets, and payroll checks.

A check is drawn for the net pay from the general account and transferred to the payroll bank account.

The payroll bank account is reconciled by checking against the payroll sheets which show the check number opposite each check.

Payroll totals, shown in the general ledger cumulatively, are reconciled with the gross pay shown on individual earnings records and tax returns are prepared and reconciled annually with total payroll for the year. Tax deductions at the source are also reconciled with remittances to tax authorities.

Often the client requires the services of men who own their own automobiles, to assist in making certain deliveries. Payments for this service, charged to "Car hire," are reflected in payrolls, but are not subject to tax deductions, etc., at the source. Payments are made on the basis of a certain rate for each delivery.

Audit of System

1. Obtain time cards for one week in November or December and note whether the time clock is used properly.
2. Total the hours and compare with the total shown on the payroll sheets. Check the extension of hours and rates. Ascertain that regular time and overtime is paid at appropriate rates by reference to the manager's employment records.
3. Check all deductions to appropriate records.
4. Foot and cross-foot payroll sheets for the week under review.
5. Compare cancelled checks with the payroll sheets for one month, examining endorsements, and check the reconciliation of the bank balance for that month.
6. Investigate checks that are outstanding for more than one month.

GENERAL AUDIT PROCEDURES

Cash in Bank

The wholesaler maintains two bank accounts, a general account and a payroll account. Verification of cash in bank is made about January 20th.

1. Obtain confirmation of year-end balances on deposit from the banks.
2. Check bank reconciliations prepared by the client, by inspection of cancelled checks for the last month of the year, and confirm deposits in transit (recorded in the cash receipts book) by direct communication with the banks, ascertaining exact date deposited.
3. Investigate checks that have been outstanding more than one month, and make necessary inquiries regarding them.

Cash on Hand

On Saturday night, the last day of the fiscal year, count the cash in the safe, which will be deposited on Monday. Saturday receipts are usually very small, consisting mainly of customers' checks. See that the total agrees with the cash book. This item must also agree with the deposit in transit, shown on the bank reconciliation and subsequently listed on the bank confirmation letter.

The company accountant must be present at this count. At the same time the petty cash imprest fund is checked and the details of vouchers, I.O.U.'s, etc., are listed. The petty cash fund is never in excess of $200, but it is important to see that no shortages exist.

Marketable Securities

These are temporary investments consisting of registered government bonds and are usually held by the bank for safekeeping. Direct communication with the bank, which furnishes full details of the securities, is considered sufficient verification. Bank interest received during the year is checked with appropriate records.

Accounts Receivable

Accounts receivable were confirmed as follows:

1. All receivables are confirmed using a negative form of confirmation. This work is done as at the last Saturday in November, which is used as the closing date for November.
2. As all weekly statements are prepared only in duplicate, one copy being handed to collectors on Monday and one copy remaining in the statement binder, a special form letter is drawn up to cover negative confirmation of city retail accounts. We check weekly statement balances to accounts receivable ledger balances.
3. All other statements are mailed; therefore we take control of all monthly statements to country dealers and subwholesale accounts.
4. Statement balances are compared with balances in the accounts receivable ledger, and control accounts are reconciled with trial balance of receivable balances as at the same date.
5. Employees of the client, under our supervision, insert letters and statements in envelopes with reply envelopes bearing our return address.
6. We count the statements and letters after checking with the ledger balances and recount the number of envelopes ready for mailing. One of our employees deposits them in the mail box.
7. We list replies showing differences and investigate them, asking for a report from the manager.

We know that city dealers' weekly accounts are due in the first week of December and are usually paid promptly, but negative confirmation is necessary because it is more effective than control of cash subsequent to the audit date in situations where these cash receipts cannot be definitely related to particular invoices or statements being paid.

A driver may pocket collections made during the last week of November and the customers' balances at November 30th would indicate certain unpaid items billed during the third and fourth weeks of November. If the driver is aware of the fact that the auditor does not confirm accounts receivable, his embezzlement would not be detected, as he may be astute enough to report a full payment of arrears during the first week of December to prevent any discussion of delinquent accounts. If no confirmation procedure is carried out, the driver then proceeds in December to hold back collections. A few complaints from customers, based on negative confirmation, will bring this defalcation to the surface.

After the close of the fiscal year:

1. The wholesaler hands us schedules, suitably aged, showing the balances of all accounts in the accounts receivable ledger. The ageing schedules are drawn up to show the accounts paid during the first three weeks of January, so that any accounts unpaid at the date of the audit can be examined. These items would comprise monthly accounts and any overdue items. The total shown in the "payment" column is reconciled with the cash receipts book.
2. We foot these schedules and agree the total with the general ledger control accounts.
3. The balances shown on the schedules are checked with the ledger balances and, after discussion with the manager, we compute the necessary allowance for doubtful accounts and unearned gross profit.
4. We also examine summaries of the accounts receivable ledger balances prepared throughout the year and ascertain whether they are in agreement with the control accounts throughout the year. In this connection, the client's staff should prepare a copy of the general ledger control accounts for the period under review.

Inventories

Inventories of the wholesaler consist of the following:

1. Saleable newspapers and magazines on hand (loose copies).
2. Newspapers and magazines to be returned to the publishers:
   a. Complete copies not yet stripped.

b. Headings and covers of magazines ready for shipment to publishers.

3. Saleable books on hand.
   (All the above items are always located on the premises. They represent about 50 per cent of the total inventories.)
4. Newspapers and magazines (in bundles not yet opened) are also on the premises. These represent about 30 per cent of the total inventories and consist of complete shipments billed by the publisher but which will be distributed to dealers after the closing fiscal period. In some cases, if not billed, an accrual must be set up for the liability.
5. Newspapers and magazines in transit; i.e., billed by the publisher but not yet received on the inventory date. These represent about 20 per cent of the total inventories.

All inventories are priced at cost and, as returns are sent to publishers promptly for credit, there are no "obsolete" items. The physical inventory is taken on Saturday noon on the last day of the fiscal year for items (1), (2), and (3) listed above. Our representative attends the client's place of business during the taking of the inventory, which is counted and called by one clerk and entered on inventory sheets which have been prepared in advance. The sheets group publications handled for each publisher, and if no copies are on hand, the space is left blank. We count the *saleable books* on hand with the client's staff, because they usually represent at least 50 per cent of the "on hand" inventories, and we compare this count with the perpetual inventory records maintained for books. The same day a member of the office staff inserts the cost price and extends and totals the inventories listed. We check this work for arithmetical accuracy and also compare prices with the "price book." We note the total on our working papers up to this point.

Newspapers and magazines (in bundles not yet opened) represent at least 35 per cent of the "on hand" inventories. It is not necessary to open these as the quantities appear on labels used by the publisher and fastened to the parcel. Our representative makes a test check of a few publishers' shipments by counting the bundles and tracing the entries to the inventory sheets.

An additional verification is made of these totals by comparing them with the publishers' statements which show the quantity and the amount of the charge. It is also possible to compare them with the receiving book, which shows the date received, and it can be noted that the insertion for the distribution date is still open.

Nothing further can be done to complete the inventory sheets until all publishers' bills are received. Then the chief accountant lists inventories in transit by reference to the receiving book and publishers' bills.

By January 20th, the date of the commencement of the audit, the completed inventory sheets are handed to us. We then make a further verification of in-transit items, checking all prices, extensions, and footings, and summarize the inventories. The date of distribution is subsequently noted by the client opposite each item of "in transit" or bulk copies not distributed, so that if the publisher does not ship an in-transit item, it can be followed up. This procedure is of particular importance throughout the year because often, although a charge is made by the publisher, he does not print, and may neglect to ship. Reorders delivered to customers during the three days preceding the close of the period are often so numerous that the charge to the customer appears on the following week's statement, and no delay occurs in completing the current statement. This "receivable" is added to inventories.

No reserves are necessary in this particular business. All publications are fully returnable to the publisher at cost, with the exception of a certain percentage of nonreturnable papers, which loss is calculated, journalized, and eliminated from inventories as already explained.

We verify the fact that liabilities have been recorded for all items included in the inventory.

Our client does not handle any novelty merchandise, commonly sold by magazine outlets, such as razor blades, pencils, postcards, etc. It was found by experience that the time and effort required to distribute these items (on a nonreturnable basis) did not bring sufficient profits and jeopardized the smooth operation of the book, magazine and newspaper departments.

We obtain a standard form of inventory certificate from the management.

Deposits

We confirm deposits by direct communication with the publishers and others, and also ascertain that interest payable on deposits has been received during the year.

Fixed Assets and Delivery Equipment

The automobiles owned by the wholesaler are verified by examining the license cards for the year.

The client hands us a detailed schedule giving the following information (headings across the top of the schedule):

Type of Truck or Auto
License No.
Date Purchased
Asset Account
- Balance Dec. 31/49
- Transactions for Period
  - Additions
  - Deductions
- Balance Dec. 30/50

Accumulated Depreciation
- Balance Dec. 31/49
- Depreciation for year
- Deductions
- Balance Dec. 30/50

We check all purchases of trucks and autos during the year with appropriate invoices. All delivery equipment is purchased for cash. We also verify depreciation provided for the year and see that maximum rates, as permitted by tax authorities, are taken. Profit or loss on trade-in is reflected in the profit and loss account separately.

Although the wholesaler's investment in fixed assets is relatively insignificant in amount in relation to total assets, detailed asset records are maintained to show cost and the related reserves for depreciation.

We trace purchases of new equipment to purchase invoices, and the client furnishes us with a schedule similar to the type prepared for the delivery equipment accounts. As we have audited the books since the commencement of operations, the details of all prior year transactions are contained in our working papers, so that our review of the accounts under this caption is confined to the current year only.

For convenience, desks and chairs are grouped in one account but items which cost over $200 are shown separately in the subsidiary ledger.

The company does not write off items that have become fully depreciated, if they are still in use, but carries them at $1 net. If, however, an item is retired, by sale or by being scrapped, the manager's approval is obtained for write-off, and the profit or less on retirement is calculated and shown as a separate item on the profit and loss statement.

If alterations are made to leased premises, a separate account is maintained as this item is written off over the term of the lease.

Deferred Charges

The program relative to deferred charges does not present unusual problems.

We are furnished with insurance schedules and make certain that the coverage is adequate and complete for fixed assets, delivery equipment and inventories. However, if the client obtains new franchises and carries larger inventories than formerly, we make certain that additional coverage is obtained and make inquiries from the manager during the year, based upon our review of monthly balance-sheets.

Trade Accounts Payable

We are furnished with trial balances of the accounts payable ledger which are checked to the ledger and agreed with the control account.

It is not necessary to confirm payables, because statements are obtained for all accounts.

We examine all reconciliations, which are attached to the publishers' statements, showing the difference between the ledger balance and the statement balance, and compare the reconciliation with the actual entries in the ledger. Any items covering returns, checks, and charges for services, etc., which appear to be overlooked by the publisher, and which are over one month old, are questioned to ascertain whether letters have been written to the publisher. The correspondence is examined, as certain returns may be in dispute, and it may be necessary to write off as a loss any returns sent back too late for credit.

December statements from publishers are checked in detail to the receiving records, inventories, and purchase journal, to ascertain:

1. That accrual has been provided for merchandise received and on hand, not billed by the publisher.
2. That accrual has been provided for merchandise, received, not on hand, but shipped to dealers and billed to dealers prior to end of fiscal year.
3. That inventories in transit include items billed by the publishers but not received until after closing date.

We obtain a letter from the client on their own letterhead, regarding inclusion of all liabilities.

Provision for Federal Taxes on Income

After we have completed our working papers and arrived at taxable profit for the year, we calculate the tax provision. Our working papers give full details of the reconciliation of net profit and taxable profit.

We check installment payments by examining cancelled checks issued during the year and comparing them with the installment remittance form used by the client.

Customers' Deposits

We are furnished with a detailed schedule of deposits contained in a subsidiary ledger and agree the total with the general ledger account.

These deposits are not confirmed, and no interest is paid. It has been customary to demand deposits of $10 to $25 from smaller retail outlets to secure payment of account in event of bankruptcy, etc. The deposit usually amounts to one week's net bill.

A duplicate receipt book is used when a deposit is received, and if the customer ceases operation, the receipt must be returned to the manager, who cancels it and issues instructions to refund the deposit by check only.

We note that the trend recently is to discontinue demanding deposits, so this account is gradually being liquidated.

Capital Stock

Because the stock is closely held, there have been very few changes in the stockholdings during the past years, nor has it been necessary for the company to issue additional shares since the original shares were issued at time of incorporation. However, we spend an hour or two examining the stock ledger, share certificate book, and minute book.

If any stock transfers have been made during the year, we note whether the tax has been paid.

Retained Income

It is the company's policy to reflect *all* prior year adjustments through profit and loss as the amounts involved are not large and usually involve adjustments of accumulated depreciation made by the tax department, and additional income tax assessed by reason of adjustments of taxable income.

We check the declaration of dividends with the minutes of directors' meetings, and examine checks issued to shareholders for dividends, comparing them with the cash disbursement book entries.

CONCLUSION

After we have received all confirmations and certificates, we prepare the closing entries and hand them to the chief accountant, who closes the general ledger. When the closing trial balance has been received from him, we carefully check it with our draft financial statements. We then proceed with the typing of our long-form report.

As the client prepares the corporation tax returns, we furnish him with a sufficient number of copies for this purpose. The client sends us a copy of all returns filed, for future reference.

We compare the current year's statements with the previous year's figures, ascertaining the reasons for increases in any expense or decreases in income accounts.

We like to discuss the results of the audit work with the client and submit the draft report for suggestion and criticism. Financial statements are prepared to show comparative balance-sheets and profit and loss statements, with a statement of application of funds and any other detailed schedules we deem necessary for management or tax purposes.

This concludes the engagement. If necessary, a separate letter is sent to the client with any suggestions which we deem necessary covering the accounting system, the system of internal control, etc.